fair valuation: jpmorgan at the forefront

The Securities and Exchange Commission (SEC) has stepped up its scrutiny in recent years of mutual fund share valuation practices in an effort to curb potential trading abuses. Here's what JPMorgan Investor Services has been doing all along to cut the problem off at the pass.

Approximately two years ago, the SEC significantly stepped up its scrutiny of daily mutual fund valuation and the issue is now making headlines for all investors to see. The SEC's focus: to eliminate much of the incentive for market timing, which, although not illegal, can give rise to trading abuses that can impact returns for the long-term mutual fund investor. As a result, the SEC has placed a greater burden on fund administrators to come up with ways to fairly value shares and ultimately, discourage trading abuses in order to safeguard long-term shareholder interests.

The Pricing Problem

The need for fair valuation of mutual fund portfolio securities has its roots in two fundamental issues: "cutoff" times for calculation of net asset values and market timing activities.

For the pricing of most U.S. domestic securities, the typical fund's late-afternoon cutoff — a 4 p.m. EST deadline for the U.S. — poses no problem. Fund companies simply value their portfolios using the last traded price of the day. Data and pricing services provide a stream of closing prices, which are then applied against the fund's holdings to calculate the value of the portfolio.

In contrast, this issue significantly impacts the many foreign securities held by U.S. mutual funds. Asian markets may close 12 to 15 hours earlier than a fund's valuation time. European markets may close up to six hours earlier. As a result, such prices are often "stale" by the time a fund's net asset value is calculated. While this has never been a secret, unfortunately an increase in market-timing activities aiming to exploit these "stale" prices has given rise to a full-blown SEC inquiry over recent months. Some would even say a crackdown.

The crux of the SEC's position rests on the fact that when short-term investors — i.e., market timers — attempt to exploit the scenario where the values of stale-priced securities in a fund are likely to have changed significantly by the time a fund uses it to calculate the net asset value. Sufficient knowledge of a fund's portfolio composition combined with an understanding of the movement of securities market prices and values give the market timers the opportunity to arbitrage the fund net asset values from day to day. This potentially harms long-term shareholders due to the erosion of earnings and capture of profits by short-term investors. It may force funds to manage a portfolio in a disadvantageous manner, whether through liquidating securities to accommodate market timers or maintaining a larger percentage of portfolio assets in cash to meet higher redemption levels.

The Solution: Fair Valuation

While there are actually a few options available to mutual funds to combat market timers, fair value pricing of mutual funds, typically executed through an automated process, is gaining in popularity as an effective solution.

Fair valuation, simply defined, is the process of assessing the price of a security that would prevail in a liquid market, assuming all significant market events were adequately "factored into" the security's value. Put another way, fair value pricing, as a rule, assigns estimates for securities that lack readily available market quotations or for later valuation of securities traded in foreign markets long after their markets have closed. Fair valuation processes are often used when market events occur after the local market close, but before a fund's daily net-asset-value calculation. While it is not an exact science, there is no doubt among leaders in the investment community that this act of vigilance is necessary to help prevent abuses and protect long-term shareholder interests.

The JPMorgan Response: Ahead of the Curve

JPMorgan Investor Services was concerned about the issues of fair valuation and market timing before they began making headlines. "We are concerned about the impact the potential disparity in prices for foreign stocks held in our U.S. portfolios can have on the bulk of our long-term shareholders," says Cynthia Davies, senior manager Fund Accounting, JPMorgan Investor Services. "We are strongly committed to taking whatever measures are necessary to prevent the abuses — however rare — that can arise from this price differential due to operating in different time zones."

The fact is, JPMorgan Investor Services put several preventative measures in place in 2001. "As challenges, particularly in the international arena, grow more complex, our work with clients has become increasingly consultative," says Virginia Meany, Funds Services Western Hemisphere business executive, JPMorgan Investor Services. "Together we have developed customized solutions to address the need for valuations that accurately reflect market realities, especially in certain emerging markets."

First and foremost, JPMorgan Investor Services took the initiative to engage the services of a third-party pricing source, such as FT Interactive Data and ITG, to provide fair market values for non-North American equities after the close of the U.S. markets. This is a move regarded by many regulators as an added safeguard that helps ensure independent and more comprehensive oversight of the process. Both firms utilize a fair valuation methodology that operates at the individual security level.

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"Our experience has enabled us to work with vendors as well as fund managers in constructing solutions that best protect the interests of shareholders," Meany says. "The 'after the close' analysis is of particular value to clients. It allows fund managers to compare the fair valued price with the market price. Having the expertise to perform the comparison and analyze the results has added value to the information we provide," she says.

"This Fair Value Model, introduced a more radical method than many other fund companies from the start in that it pursued a bottom-up approach to fair valuation," said Russell Warren, director of Fund Accounting and Administration, JPMorgan Investor Services. "For example, fair value pricing essentially assigns an estimate for international equities that lack readily available market quotations. Many firms then utilized — and still do — a process that would fair value the *entire portfolio*, as a whole entity," explains Warren, "whereby fund leadership would view the events of the day and decide whether market events were significant enough to warrant fair valuation. If so, they would assign what they believed to be a fair value price to a portfolio of securities."

"Conversely," notes Warren, "the JPMorgan methodology elected and still uses bottom-up valuation, a method that allows the client to derive fair values for its portfolios by adjusting the individual prices of securities in a fund, instead of the portfolio as a whole. Because of the volume of securities potentially affected, JPMorgan Investor Services also elects an automated approach, which is generally regarded as more efficient and certainly more cost- and time-effective."

The process is driven by a series of "triggers," approved by fund managers, that alert the fund administrator and the pricing vendor that the fair valuation methodology must be used. (An example of a trigger would include if a certain stock market index, for example the S&P 500 or the Russell 1000, changed by a certain percentage, this would represent a major move in the financial markets, and therefore qualify as a trigger.) Once a trigger is hit — and the list of possible triggers can be extensive, factoring in a number of possibilities in the marketplace — all of the security level fair valued prices that are provided by the vendor are then applied to those earmarked securities. In terms of volume, Davies estimates that roughly 60–80 % of JPMorgan Investor Services' portfolios are potentially affected.

According to Paul Shield, product manager, JPMorgan Investor Services, "It's one thing to select a vendor and apply fair valued prices to a portfolio but there is so much more to the issue. An administrator needs to also set up a monitoring and communication process that facilitates timely decision making by fund managers to ensure the interests of fund shareholders are represented."

Fair Value Pricing: Is it Worth the Effort?

The logical question many investors might have is — how effective is fair value pricing? Or even more basic, can its effectiveness be measured at all? Warren responds with a resounding, "Yes. One of the regular checkpoints we employ to test the efficiency of a fair value process," he says, "is to see whether the next day's opening prices move in the same or opposite direction as the fair value adjustments." Shield agrees, "Often, when the market is active or there's a significant event or shift in the market," he says, "you'll see the fair value price is directionally closer to the opening price. This 'test,' if you will, has proven that the model we've selected and process we employ is, in fact, effective in reducing market timing."

Overall, the commitment to ensuring that a sound fair valuation process is in place is evidenced by JPMorgan Investor Services' long-term actions. "We offer clients more than just data," Meany explains, "we offer the intelligence gained from years of experience dealing with markets, pricing practices and vendors." Davies adds, "It's important to our customers and their shareholders that we try to assist funds in discouraging market timers. Market timing activity can increase portfolio turnover and transaction costs for the fund, which directly impacts long-term investors. For that reason alone, we're prepared to do whatever it takes to help funds continue the fight. Fair valuation pricing is a key weapon." ○○○